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Secured Real Estate Financing: Mortgage Defaults and Power of Sale Proceedings

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With rising interest rates and falling commercial real estate prices, we may be entering (or perhaps are already in) a period of increased commercial mortgage defaults and power of sale proceedings.

This is, therefore, a good time to review the rights and remedies of lenders and borrowers in these scenarios.

When a commercial borrower fails to make a mortgage payment to its lender when due, a default occurs, entitling the lender to various legal remedies.

One of these remedies in Ontario is the power of sale. Under Part II, section 24 of the Mortgages Act of Ontario (the "Act"), three months after default the mortgagee has the power to sell the whole or any part of the mortgaged property by public auction or private contract. The money from this sale is applied, after payment of all expenses, to repay all principal, interest and costs due under the mortgage.

The power of sale can also expressly be set out in the mortgage itself, and section 30 of the Act provides that the power of sale provisions under Part II of the Act do not apply to a mortgage that contains power of sale provisions.

The following are some common or required procedural steps once a mortgage default occurs:

1. The lender issues a letter to the borrower and guarantors demanding repayment of all amounts owing to it under the mortgage.

2. In addition to the demand letter, the lender will usually also notify the borrower and guarantors of its intention to enforce its security under section 244 (1) of the Bankruptcy and Insolvency Act of Canada. The secured creditor shall not enforce the security in

respect of which the notice is required until the expiry of 10 days after sending that notice, unless the insolvent borrower consents to an earlier enforcement of the security.

3. During this 10-day notice period, the borrower may repay or negotiate repayment terms with the lender resulting in an amendment or extension of the loan agreement. Alternatively, the lender may enter into a forbearance agreement with the borrower, allowing the borrower more time for full repayment in exchange for immediate partial repayment or other consideration.

4. When the parties cannot reach an agreement on repayment terms after the 10-day notice period, the lender may issue a Notice of Sale under section 31 of the Act to all persons who have an interest in the property. If the amount owing under the mortgage loan is not fully repaid within 35 days after the issuance of the notice, then the lender may sell the property.

During this 35-day period, a borrower may continue to negotiate repayment terms with the lender or, alternatively, try to arrange a refinancing or sale of the property on terms agreeable to the lender. However, no further proceeding and no action can be commenced or taken by the lender, including listing the property or agreeing to sell it.

Lenders must also be cautious with enforcement steps to follow the prescribed rules of the Act on who should receive notices, their content and timing deadlines. Otherwise, a borrower could argue that procedure has been violated which could result in a termination of a potential sale of the property.

Similarly, the borrower must exercise caution in its action in certain circumstances once the notice period has expired. For example, if the property has tenants and the lender has issued a notice of attornment of rents to collect the monthly rental payments from each tenant, the borrower cannot interfere with the collection of payments.

When selling a property pursuant to the power of sale remedy, lenders have a duty to all those with an interest in the property, including the borrower as well as any other lender who has a mortgage on the property, not to improvidently sell the property. The lender must act with reasonable care and try to sell the property for the best price in the circumstances or risk being liable to those with property interests for any deficiency via an action for improvident sale.

There were several court cases involving power of sale proceedings adjudicated in the early 1990s in Ontario following a real estate downturn with similarities to what we are starting to see in the market today. Given the potential pitfalls of mortgage enforcement alluded to above, lenders and borrowers who find themselves in a mortgage default scenario where power of sale proceedings are possible, should seek expert legal advice early in the process to avoid undesirable outcomes.

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